a. Conflicts of Interest

In the context of a possible merger, the duty of loyalty would require disclosure of any possible conflicts of interest if the director directly or indirectly may have an interest in the transaction, financial or otherwise, that might be considered to conflict with the best interests of the corporation. For example, a director may have an employment or investment relationship with the potential merger partner, may have a family relationship with a principal in such an entity, or may be providing professional services to such entity. Other possible conflicts of interest are the receipt of offers of employment from the potential merger partner, ownership interest in the potential merger partner, or receipt of payments not to compete. All directors should be sensitive to these potentially conflicting relationships and must act with candor and care in dealing with such situations.

A transaction involving an interested director is not voidable solely because the director participates in the meeting which authorizes the transaction, even if the interested director's vote is counted, if: (1) the transaction is approved by a majority of disinterested directors, (2) the material facts about the director's interest are disclosed and the transaction is approved by shareholders, or (3) the transaction is fair to the corporation at the time it was authorized, approved or ratified.[16] Any transaction that is not deemed fair and reasonable will be voidable by the corporation.

b. Interlocking Boards

In the context of a conversion and business combination, the CareFirst directors should be sensitive to the structural conflicts of the holding company system, particularly when a director sits on more than one CareFirst board. Directors who act in a dual capacity owe the same duty of care to both corporations and must exercise this duty in light of what is best for both corporations. If potential merger partners have common directors, that circumstance would be considered in testing the validity and good faith of the transactions between them.

II. Fiduciary Duties in the context of the CareFirst Transaction

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[16] Del Code Ann. Gen. Corp. Law §144; Md. Code Ann. Corps. & Ass'ns §2-419. D.C. does not have a similar provision.

The above standards are more or less straightforward; however their application in the context of a possible CareFirst transaction is more difficult. Because the corporation has no shareholders, the director's duties are potentially owed to policyholders, members, insureds and other groups, depending on the statute. What follows in Part A highlights the relevant statutory sections and discusses the various fiduciary duties they raise. Part B examines some of the relevant case law and the conclusions to be drawn therefrom.

A. Statutory Standards

1. Maryland

In the context of converting[17] CareFirst to a for-profit entity, a number of review criteria of the Maryland Insurance Administration (the "Administration") reflect criteria the Directors themselves should consider.

The Administration will not approve acquisitions/conversions that are not in the public interest. An acquisition is deemed not to be in the public interest unless (among other things) steps have been taken to ensure that the value of the public or charitable assets is safeguarded. SG §6.5-301(a). Among other factors that the Administration considers when determining if an acquisition is in the public interest are: 1) whether the transferor exercised due diligence in all aspects of the transaction; 2) whether appropriate decision-making procedures were used; 3) whether any conflicts of interest on the part of the executives and directors were disclosed; 4) whether the transferor will receive fair market value for its assets; and 5) whether the acquisition will likely have an adverse effect on the availability or accessibility of health care services in the affected community and whether those affected will have continued access to affordable health care. SG6.5-301(e).

In deciding whether to approve the acquisition/conversion of a nonprofit health service plan, the Administration must also consider: 1) whether the acquisition is in the public interest; 2) whether the acquisition is equitable to enrollees, insureds, shareholders,

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[17] Title 6.5 of the State Government Article of the Annotated Code of Maryland (1999 Replacement Volume) includes "a conversion to a for-profit entity" in its definition of acquisition. SG §6.5-101(b).

and certificate holders;[18] 3) whether the acquisition is approved by at least two-thirds of the nonprofit entity's certificate holders who have voted on the acquisition; and 4) whether the acquisition ensures that the entity will comply with the applicable surplus requirement and be able to provide for the security of the certificate holders and policyholders. SG §6.5-303.

In the context of acquiring control of a Maryland Domestic Insurer or Insurance Holding Company, the Administration must also approve, or at least not disapprove, the transaction. The Administration will disapprove a transaction if it finds that (among other items) the financial condition of the acquiring person might prejudice the interests of its policyholders; the acquiring person has plans that are unfair to policyholders; or it would not be in the best interest of the policyholders or public to allow the acquiring person to control the domestic insurer based on the competence, experience and integrity of the persons that would control the operations of the domestic insurer. IN §7-306.

Therefore, in the conversion context it will be extremely important for the directors to consider any aspects of the transaction/conversion/merger that might affect the public interest in an adverse way. In addition, the directors must be especially careful to ensure fairness not only to its members, but to its enrollees, its insureds and its certificate holders. Because disapproval in the context of a merger can ride not only on prejudice to the public interest but also on prejudice to the interest of CareFirst's policyholders, it will also be important for the directors to consider these interests throughout each step of deliberation on the proposed merger.

2. Delaware

Delaware law does not contain any statutes that specifically address the conversion of a nonprofit health services corporation to a for-profit entity. Nevertheless, the Delaware Insurance Commissioner must approve a merger or an acquisition of control of a Delaware domestic insurer. 18 Del. Code §5003. Approval is required unless some negative findings are made such as: 1) the financial condition of the acquiring party might prejudice the interests of the insurer's policyholders[19]; 2) the acquiring person has plans to make material changes in its business/corporate structure or

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[18] The Maryland Code does not provide definitions for "enrollees," "insureds" or "certificate holders."

[19] The Delaware Code does not define this term.

management that are unfair and unreasonable to policyholders of the insurer and not in the public interest; 3) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policy holders of the insurer and of the public to permit the merger or other acquisition of control; or 4) the acquisition is likely to be hazardous or prejudicial to the insurance buying public. 18 Del. Code §5003(d)(1).

The issues of concern for directors in Delaware are similar to those in Maryland. Directors must look out for the interests not only of the company's policyholders but of the insurance buying public as well. Again, these interests must be considered throughout the merger process.

3. District of Columbia

A corporation issued a certificate of authority by the Mayor may convert to a for-profit entity under a plan and procedure approved by the Mayor. 35 D.C. Code §4715. The mayor is required to approve any plan or procedure unless the Mayor finds (among other items) that the plan: 1) is inequitable to contractholders of the converting company or to the public or 2) provides that any part of the assets will inure directly or indirectly to any officer, director or trustee of the corporation. 35 D.C. Code §4715(b).

The Mayor is required to approve or disapprove a merger. 35 D.C. Code §3703(g)(2). The District of Columbia's approval standard is much like those of Delaware and Maryland. The Mayor must approve the transaction unless the Mayor makes a negative finding such as: 1) the financial condition of the acquiring party might prejudice the interests of the insurer's policyholders; 2) the acquiring person has plans to make material changes in its business/corporate structure or management that are unfair and unreasonable to policyholders of the insurer and not in the public interest; 3) the competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policy holders of the insurer and of the public to permit the merger or other acquisition of control; or 4) the acquisition is likely to be hazardous or prejudicial to the insurance buying public. 35 D.C. Code §3703(g)(1).[20]

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[20] Note that this provision is identical to 18 Del. Code §5003(d)(1).

As is the case in Maryland and Delaware, directors in the District must look out for the interests of a variety of entities. First, the directors must be sure, in converting, that the plan is fair to contractholders and the general public. Second, the directors cannot gain any part of the assets from the transaction. During the merger, the directors must also look out for the interest of policyholders and the insurance buying public in general.

4. Virginia

Virginia law on conversion is codified at §38.2-1005 and 38.2-1005.1 of the Virginia Annotated Statutes. These provisions provide that certain mutual companies and societies and domestic mutual insurers may not convert to stock companies without the approval of the State Corporation Commission. The statute refers explicitly to domestic mutual insurers with no mention of foreign mutual insurers. Therefore, Virginia would not regulate CareFirst in the conversion/merger transaction since CareFirst is not a domestic company in Virginia.

B. Case Law

There are few court cases examining the role of directors in the conversion of merger of a not-for-profit corporation. This is in part because of the swift legislative reaction to perceived self-dealing in early conversion transactions. For example, when management of Blue Cross of Ohio accepted an offer to be sold to Columbia/HCA, four executives were to receive $19 million in payouts as part of the transaction, and seven former directors were to receive $3 million. The size of these payouts raised questions about the integrity of the organization's decision-making process as well as the quality of information provided by the staff to the board. The response of several jurisdictions has been to introduce legislation prohibiting bonuses as part of such transactions.[21].

Also early in the history of such transactions, the Michigan Attorney General convinced a judge to stop a joint venture on the grounds that the public interest was not

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21 *See, e.g.*, James Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-profit Status*, 23 J. CORP. L. 701, 718 (1998) (citing the Colorado Code which has prohibited converting corporations from going public within three years of a conversion). Usually the former nonprofit managers would own substantial sums of stock as a form of bonus, which would become enormously valuable on a public offering. *Id.* at f.n. 99.

protected.[22] The court blocked the joint venture on the basis that a nonprofit's assets cannot be commingled with those of a for-profit corporation under Michigan's Nonprofit Corporations Act. However, the court did state that a sale of the assets would be permitted.

In another example, a Missouri state court judge was seemingly lobbied into holding that a nonprofit entity was of a charitable nature. In 1994, the Missouri Department of Insurance ("DOI") approved a transaction whereby Blue Cross and Blue Shield of Missouri ("BCBSMO"), a nonprofit health services corporation, transferred 80 percent of its assets to a for-profit subsidiary. After the insurance commissioner decided that this "reorganization" actually amounted to a conversion, he sought to retain the charitable assets of BCBSMO.

On September 9, 1996, a Missouri judge ruled that BCBSMO had no public benefit obligation arising from its 1994 creation of a for-profit subsidiary.[23] On December 30, 1996, the court reversed itself while ruling on a counterclaim in the same case,[24] holding that BCBSMO had exceeded its authority when it shifted 80 percent of its assets to a for-profit subsidiary. The judge also held that the DOI could amend its approval of the reorganization. The ruling cleared the way for the judge to require BCBSMO to transfer its assets to a charitable entity.

As these examples illustrate, several courts have joined the fight to ensure that the charitable purposes are not lost in the process. For their own protection, CareFirst's directors must carefully consider all aspects of any proposed transaction for possible effects on the public interest or the well-being of policyholders, contractholders, insureds, and other affected groups.

C. Valuation Issues

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22 *See* Kelley v. Michigan Affiliated Health care System, Inc., No. 96-83848-CZ (Mich. Cir. Ct. Sep. 5, 1996).

23 Missouri Blues Win Suit Against the State; Court Finds No Public Benefit Obligation, 5 Health L. Rep. (BNA) 1387-88 (Sep. 19, 1996).

24 *See* Blue Cross and Blue Shield v. Angoff, No. CV 196-619 (Mo. Cir. Ct. Dec. 30, 1996).

Often at the heart of conversion controversies are difficult issues of valuation. In the CareFirst context, relevant statutes support the view that maximizing value is not required. For example, in Maryland, the statute discusses the receipt of the "fair value"[25] of the public or charitable assets. Likewise, in the District of Columbia, the Corporation Counsel may not approve a conversion of a nonprofit unless steps have been taken to safeguard the value of its charitable assets.[26] Significantly, neither statute discusses or implies the need for obtaining the highest price possible but only the "fair value" or safeguarding of the "value" of the charitable assets. This is consistent with the notion that *Revlon* duties do not apply in the context of a possible CareFirst conversion/merger, and therefore factors other than price may be considered by the board. At the same time, directors of nonprofits must ensure that they discharge their duties of care by safeguarding the value of the nonprofit's assets in the transaction so that the organization will continue to satisfy its charitable purposes and that the interests of the community are protected.[27] Accordingly, directors can not be blind to the valuation of the enterprise in the transaction. The CareFirst board of directors will want to rely on a "fairness opinion" from experts at valuing nonprofit health care companies, because the valuation process of a nonprofit is more complex and uncertain than the valuation of a comparably-sized for-profit due to the fact that there is no readily ascertainable market value.

Traditionally in health care transaction three different methods of valuation are used: 1) replacement cost or asset valuation; 2) market comparison, which involves setting the sale price in relation to comparable assets; and 3) the most widely used method, discounted cash flow analysis, which establishes a price by projecting a health provider's earning potential.[28] Some commentators have recommended that legislation

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25 The Maryland Insurance Administration may consider all relevant factors in determining fair value, including: the value of the nonprofit health entity or an affiliate or the assets of such an entity that is determined as if the entity had voting stock outstanding and 100% of its stock was freely transferable and available for purchase without restriction; the value as a going concern; the market value; the investment or earnings value; the net asset value; and, a control premium, if any. §6.5-301(d).

26 32 D.C. Code §553 (1999).

27 Naomi Ono, *Boards of Directors Under Fire: An Examination of Nonprofit Board Duties in the Health Care Environment*, 7 ANNALS OF HEALTH L. 107, 130 (1998).

28 Fishman, *supra* note 2, at 719.

require a "market test".[29] Under this approach, any Blue Cross that is up for sale or conversion would be required to offer itself to other bidders beyond the initial offeror once the nonprofit board has reached a decision to sell or convert. The requirement of a market test would entail public disclosure of the proposed transaction, the release of relevant information to responsible persons, an adequate time period for competing offers to be made, and prohibitions on lock ups and other devices which would taint the test.[30]

Under current law, however, there is no absolute duty to maximize financial return in the CareFirst context. Rather, factors other than price may be considered, and the board is not required to accept the highest price if other factors outweigh the financial considerations. Whether or not to recommend acceptance of a particular bidder is within the business judgment of the board. It may be that the higher financial bid will not be the best for the organization as a deliverer of healthcare, the financial situation of the higher bidder may be precarious, or some other factor may dictate that the higher price may not produce the best result for the organization.

While this reasoning is consistent with the conclusion that the Business Judgment Rule, and not the more stringent *Revlon* standards, will govern the CareFirst Board's decision-making process, there is only one court decision that has addressed the issue in the context of the conversion of a health care company. In that case, a Californian nonprofit HMO, Family Health Plan (FHP), applied for conversion. Its board of directors had valued its assets at $13.5 million. The California Department of Corporations rejected the valuation and proposed $47 million as the fair market value. The Department then negotiated a $38.5 million price which included $7.2 million in cash and the rest paid over ten years.[31] Another for-profit HMO made a competing offer to buy FHP for $50 million and sued, along with the California Attorney General, to require FHP to accept the highest bid. At the time both the president of the company giving the competing offer and the FHP's own documents indicated that FHP's fair market value

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[29] Fishman, *supra* note 2, at 720 (citing Harvey Goldschmid, *Nonprofit Conversion Transactions: Existing Fiduciary Duties and Necessary Reforms, in* CONVERSION TRANSACTIONS: CHANGING BETWEEN NONPROFIT AND FOR-PROFIT FORM 1 (1996)).

[30] *See* Fishman, *supra* note 2, at 719 (citing RONALD GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1020-23 (2d ed. 1995)).

[31] Fishman, *supra* note 2, at 707.

might have been substantially higher. In an unreported decision, the court permitted the conversion to for-profit status holding that the law did not require sale to the highest bidder.[32]

D. Other Issues

In order to comply with charitable requirements, a converting nonprofit entity may give its charitable assets to an existing charity or it may create a new charitable foundation. In certain transactions, charitable proceeds have been used to support government programs. In some early California HMO conversions, charitable proceeds were used to support the MediCal program. More recently, a majority of the assets from the conversion of Trigon Blue Cross in Virginia were used to support the state's higher education budget. In most cases a new foundation is created. Approximately 60 new foundations were formed for various HMO and Blue Cross Blue Shield conversions between 1990 and 1997, with assets estimated in the $5 billion range.

In the transaction at hand, three of CareFirst's subsidiaries will convert to for-profit status before the business combination, thus necessitating the disposal of their charitable assets. Maryland specifies that the assets of a Maryland insurer will go to the Maryland Health Care Foundation; Delaware and the District of Columbia do not designate a specific charity. Nevertheless, since the purpose is to benefit the public interest of a particular state, and given that previous conversions allocated their charitable proceeds to support in-state causes, it seems likely that the Delaware and D.C. CareFirst subsidiaries will need to give their assets to a new in-state foundation or an existing in-state charity in their respective jurisdictions.

E. Conclusion

In the context of conversion and merger, CareFirst's Board of Directors for its subsidiaries involved in the transactions must act with good faith and in the reasonable belief that their actions are in the best interest of policyholders/contractholders, insureds and the public interest in general. Presumably the Board of Directors of CareFirst itself owes the same duties but not limited to the parties in a specific state. Rather, the

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[32] *See* Fishman, *supra* note 2, at 707 (citing Maxicare Health Plans v. Gumbiner, No. C-565072 (Los Angeles Superior Court, 1986)).

directors would be required to safeguard the interests of policyholders, insureds and other affected groups in all the relevant states.

The board must insure that the transaction does not involve self-dealing and must be comfortable that the price received, while not necessarily the highest offered, is sufficient to safeguard the value of the insurer's assets for the public. If these standards are met, the board may also consider non-price factors in determining whether to approve a transaction and may take comfort in knowing that their deliberations will be governed by the Business Judgment Rule and not the stricter *Revlon* standards.

Summary of Fiduciary Duties and Statutory Standards Relating to Possible Business Combinations[33] Of CareFirst

	Common Law Fiduciary Duties	Issues re: fiduciary duties	Statutory Standards for Conversion	Statutory Standards for Acquiring Control
Maryland	• General oversight responsibility. • Duty of care. • Duty of loyalty.	• Directors may rely on experts. • Business judgment rule is generally applicable. • Conflicts of interest are not a disqualifier if disclosed. • Interlocking boards may create conflicting interests.	• Is the transaction in the public interest? • Was appropriate due diligence exercised? • Were all conflicts of interest disclosed? • Was the fair market value for assets received? • Was there an adverse impact on health care services?	• Is the acquirer financially sound? • Is the transaction fair to policy holders? • Is the acquisition in the best interests of policy holders? • Is the acquisition in the Public interest?
District of Columbia	Same[34]	Same	None	Same
Delaware	Same	Same	• Is the transaction fair to contract holders? • Did any assets inure directly or indirectly to any director/officer/ trustee?	Same

[33] *See* the accompanying memo for a more complete and accurate picture of the topics laid out herein.

[34] The duty of care is not mentioned in the D.C. Statutes, however, given the prevalence of the doctrine and the numerous D.C. cases that have discussed this fiduciary duty, its existence in D.C. can be implied.

Piper Rudnick

Exhibit B

PIPER MARBURY RUDNICK & WOLFE LLP

MEMORANDUM

To:	Board of Directors of CareFirst, Inc., CareFirst of Maryland, Inc., Group Hospitalization and Medical Services, Inc., and BCBSD, Inc.
From:	R. W. Smith, Jr.
Date:	November 30, 2001
Subject:	Agreement with WellPoint

At the Board of Directors meeting which was held on November 20, 2001 the Board of Directors of CareFirst, Inc. ("CareFirst") considered and approved the Agreement and Plan of Merger with WellPoint Health Networks, Inc. ("WellPoint"). During the course of the Board of Directors meeting, the Board was provided information with respect to the proposed transaction, including a fairness opinion from Credit Suisse First Boston Corporation, reports and recommendations from management of CareFirst and the Strategic Planning Committee of the Board, and summaries of the terms of the Agreement. In addition, I provided to the Board of Directors an analysis of its duties as directors in connection with consideration of the Agreement and the transactions contemplated thereby. The advice provided to the Board, the deliberations by the Board at the meeting and the various information provided to it culminated a long planning process that lasted for over a year. During this long process, the Board and the Strategic Planning Committee received significant information and reports regarding the options available to CareFirst and the financial, legal and other considerations that should be taken into account by the Board in reaching any decision on a proposed transaction.

The Board has requested that I confirm in writing certain oral advice provided to the Board during the course of its deliberations on November 20. This will confirm my oral advice to the Board that (i) the record clearly indicates that the Board received sufficient information to make an informed decision with respect to the WellPoint proposal and demonstrates that the Board satisfied its duty of care, (ii) the Agreement as presented includes terms that appropriately protect the ability of the Board to consider other proposals if required to do so in order to satisfy its fiduciary duties in the future, and those provisions are consistent with terms which courts generally have found to be enforceable, and (iii) based upon this overall record, the Board is entitled to exercise its business judgment to approve the proposed transaction with WellPoint, and any such decision by the Board is supported by the record and defensible.

In connection with providing this advice, I specifically noted that the Board of Directors received during the course of its consideration of its strategic alternatives

PIPER MARBURY RUDNICK & WOLFE LLP

inquiries and expressions of interest from Anthem Inc., including most recently a letter from Anthem dated November 12, 2001 stating that it wished to open up a dialogue and conduct due diligence in pursuit of a possible transaction. Stuart Smith from Credit Suisse First Boston indicated to the Board the reasons why Anthem was not included in the strategic planning process in the past and expressed his views as to why the Board should not defer a decision on the proposed WellPoint transaction to explore an uncertain transaction with Anthem. This also confirms my advice to the Board that it was not inconsistent with the Board's exercise of its fiduciary duties for it to choose to not explore a transaction with Anthem at this time and to approve the transaction with WellPoint.

Based on the advice of its financial and legal advisors and the recommendations from management and the Strategic Planning Committee, the Board of Directors approved the transaction with WellPoint at the November 20 meeting, and the Agreement and Plan of Merger was executed between CareFirst and WellPoint on November 20, 2001.